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Filed via ECFS

Ms. Marlene H. Dortch
Secretary
Federal Communications Commission
445 12th Street, S.W. TW-A325
Washington, D.C. 20554

Re: *Ex Parte* Presentation, Appropriate Framework for Broadband Access to the Internet Over Wireline Facilities, CC Docket Nos. 02-33, 01-337

Dear Ms. Dortch:

Attached for inclusion in the record of the above-referenced proceeding is a corrected declaration by Michael D. Pelcovits, Principal, Microeconomic Consulting & Research Associates, Inc. (MiCRA), on behalf of MCI, Inc. In an ex parte filed September 3, 2003, this report inadvertently referred to merger conditions placed on the AT&T/Comcast merger. The reference should have been to the AT&T/MediaOne merger. The attached declaration reflects this correction.

In accordance with section 1.1206 of the Commission's rules, 47 C.F.R. § 1.1206, an original and one copy of this memorandum are being filed with your office.

Respectfully submitted,

/S/
Richard S. Whitt

Attachment

cc: Scott Bergmann, Matthew Brill, Michelle M. Carey, Jane E. Jackson, Christopher Libertelli, William F. Maher, Jr., Terri Natoli, John Rogovin, Jessica Rosenworcel

Daniel Gonzalez Carol Mattey John P. Stanley
Lisa Zaina

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Appropriate Framework for Broadband	)	WC Docket No. 02-33
Access to the Internet over Wireline Facilities	)	

Declaration of
Michael D. Pelcovits
On Behalf of
MCI Inc.

I. Qualifications

My name is Michael D. Pelcovits. I am a Principal of the consulting firm Microeconomic Consulting & Research Associates, Inc. ("MiCRA"), which specializes in the analysis of antitrust and regulatory economics. My business address is 1155 Connecticut Avenue, N.W., Washington, D.C. 20036.

I joined MiCRA in October 2002. Prior to this, I was Vice President and Chief Economist at WorldCom, Inc. (WorldCom). In this position, and in a similar position at MCI Communications Corporation (MCI) prior to its merger with WorldCom, I was responsible for directing economic analysis of regulatory and antitrust matters, before federal, state, foreign, and international government agencies, legislative bodies, and courts. Prior to my employment at MCI, I was a founding principal of the consulting firm, Cornell, Pelcovits & Brenner. From 1979 to 1981, I was Senior Staff Economist in the Office of Plans and Policy, Federal Communications Commission.

I have testified or appeared before the Federal Communications Commission, many state regulatory commissions, the Office of Telecommunications (Oftel) of the UK government, the European Commission, the Ministry of Telecommunications of Japan, and the Civil Aeronautics Board. I have lectured widely at universities and published several articles on telecommunications regulation and international economics.

I hold a B.A. from the University of Rochester (*summa cum laude)* and a Ph.D. in Economics from the Massachusetts Institute of Technology, where I was a National Science Foundation fellow.

II. Introduction and Summary

The FCC is proposing to remove its pro-competitive rules that govern the nexus between the basic telecommunications and enhanced information services provided by the incumbent local exchange carriers (ILECs). These rules have been used for decades to limit the ability of the ILECs to leverage their market power in the provision of local exchange service and dominate the market for the provision of information services. Eliminating these rules as the Commission proposes would result in reduced consumer choice for providers of broadband-based services, applications, and devices and higher prices for broadband-related services.

Under the Commission's proposed rule changes, the ILECs would be freed from the requirement under the *Computer III* rules that they offer broadband transport on a just, reasonable, and nondiscriminatory basis to enhanced service providers (ESPs). This would have the immediate effect of drastically curtailing, if not completely eliminating, the ability of competing Internet service providers to provide broadband-based services, applications, and devices to end users. Furthermore, it would be the first step on a slippery slope that would allow the ILECs to bundle additional information services with communications services, and thereby remove those

services from common carrier regulation.[1] This would enable the ILECs to evade regulations that are intended to control their market power.

III. ILECs Will Not Offer Wholesale Access to Facilities Unless They Are Compelled To Do So

The ILECs have the incentive, ability, and track record of leveraging their market power in the *upstream* communication transport market into the *downstream* information services markets that rely on transport. The ILECs' incentive stems from a number of factors. First, they have an incentive to protect large profit margins earned on upstream services. When wholesale inputs must be provided to competitors at reasonable rates, those competitors then may be able to undermine the excess prices charged by the ILECs for these services. Second, the ILECs can earn greater total profits by engaging in price discrimination in downstream markets. In order to preserve their ability to price discriminate, the ILECs will need to foreclose competition in the downstream market. Third, denial of access to downstream competitors makes it more difficult for these same competitors to enter the upstream market and challenge the ILECs' dominance in this market.

A. The ILECs' Incentive to Protect Highly Profitable Upstream Services

Although the ILECs' retail telecommunications services are regulated, there are some products on which they earn significant profit margins. The two products most likely to be affected by the widespread development of competition in downstream markets are: residential second lines and dedicated T1 circuits sold to business customers.

[1] For example, if the ILEC offered voice over Internet protocol (VOIP) bundled with its other communications service, this voice service would become an enhanced service. It is my understanding that under the Commission's proposed rule changes, this would remove the underlying telecommunications services provided in the bundle from common carrier regulation.

Profit margins from second lines are very large, because most of the plant necessary to provide second lines is already in place. One analyst estimated that profit margins for second lines often exceed 70%.[2] When a customer replaces a second line with DSL, the net impact on an ILEC's profits is composed of its profit margin on the DSL product minus the lost profits on the second line. This means that the ILEC will have less incentive to provide DSL, and will set a higher price for DSL, than would an independent downstream provider that is not trying to protect profits from second lines. In order to limit competition from downstream competitors, the ILEC will have an incentive to deny access to its broadband transport and to its unbundled network elements, or at the least to raise the price of these upstream services well above their actual cost.

The ILECs have identical incentives to prevent competitors from cannibalizing their revenues from T1 and other high capacity dedicated business services. The FCC has recognized that DSL-based services can be a substitute for T1 service.[3] In fact, most ILEC broadband ISPs do not provide the symmetric bandwidth capabilities necessary to allow business customers to substitute DSL for T1, even though this capability can be provided at modest incremental expense.[4] In addition, in order to protect their profits from T1 service, the ILECs have demonstrated that they will discriminate against downstream competitors that attempt to undermine the ILECs' strategy by using their facilities to provide high speed DSL. This is evidenced by the ILECs' strong market share in the provision of internet service over DSL – the four BOCs are the top four providers of DSL service - while independent ISPs have a greater market share for dial-up service.[5]

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[2] Robertson Stephens, *DSL Market: Demand Doesn't Seem To Be An Issue, But Carrier Deployment Execution Does* (January 3, 2001).
[3] Federal Communications Commission, *Second Section 706 Report* ¶¶ 101 n.133, 103.
[4] Declaration of Ian T. Graham, Attachment to Joint Comments of WorldCom Inc., The Competitive Telecommunications Association, and the Association for Local Telecommunications Services, CC Docket No. 02-33, May 3, 2002, ¶44.
[5] Patricia Fusco, *Top U.S. ISPs by Subscriber: Third Quarter 2002 Analysis,* ISP Planet, November 15, 2002.

It is important to recognize that regulation of the price of upstream services does not by itself guarantee that competitors can serve these downstream markets. In the past, the ILECs have engaged in anticompetitive practices, such as degrading service or delaying provisioning, in order to raise rivals' costs. Even though competing firms have occasionally managed to survive in the downstream markets in the presence of these tactics, and reduce the ILECs' excess profits from these services, regulation that limits the ILECs' ability to engage in these anti-competitive practices will also be necessary.

B. Incentives to Engage in Price Discrimination

Monopolies (or dominant firms) will also try to leverage their market power into downstream markets in order to enable price discrimination and thereby increase profits.[6] For price discrimination to be profitable, it is necessary that customers for the downstream services be segmented into groups that have a different willingness to pay for these services. The upstream firm must vertically integrate into the downstream market in order to implement this strategy. Merely setting a high price for the upstream service will not suffice, because the monopolist must foreclose downstream competitors to prevent them from eroding the market segmentation that is the key to successful price discrimination.

When an ILEC can segment customer groups successfully and engage in price discrimination, the prospect of increased profits gives the ILEC an increased incentive to integrate into the Internet service and content market and preclude competitors. One example of the ILECs' ability to implement price discrimination is the successful segmentation of the DSL market into services that are more tailored to business users, who have a greater demand for higher-speed products, and the lower-speed services that are relied upon by residential customers. Price

differences for these services almost certainly do not reflect cost differences, but rather the customers' willingness to pay. This is a straightforward case of successful price discrimination.

The ILECs may also seek to enter and monopolize content markets, if customers that demand certain types of content (e.g., high speed access to financial markets) were willing to pay more for broadband access than others. By integrating into the content market, the ILEC could charge these customers above-cost rates for the broadband services, without repressing demand from other customers who value broadband access much less.

C. Integration and Foreclosure to Protect Profits

Preserving profits can be as important as increasing them. ILECs have an entrenched monopoly in the market for narrowband services, and they can reinforce barriers to entry in this market by foreclosing competitors in the broadband market. In particular, by denying the CLECs access to essential inputs for broadband services, the ILECs would become the only game in town – namely, the only provider of bundles of voice and high-speed Internet access. This could have a substantial effect on competition, because bundling has become an increasingly important competitive strategy. Bundling can reduce costs to the extent there are production efficiencies across services. Bundling can also increase the "stickiness" of customers to a particular carrier, and thereby decrease the costs of churn. Finally, if a CLEC cannot offer a bundle, it will be forced to serve a much smaller base of customers.

An ILEC that is successful at earning monopoly profits from broadband access will need to protect its monopoly (or share of the duopoly) from competition by new entrants (such as the wireless or satellite companies, discussed above). By tying broadband access to Internet service and content, an ILEC company may make it more difficult for these new entrants to gain a

[6] Dennis Carlton and Jeffrey Perloff, *Modern Industrial Organization,* Harper Collins, 1994, at 509

foothold and compete successfully in the broadband market. If an ILEC ties use of broadband transport to subscription to its ISP service, it will exercise a degree of control over its customer base that will make it harder for competitors to enter the broadband market.

In fact, the ILECs themselves made precisely this argument when they raised the possibility of cable company foreclosure of downstream competitors. The ILECs raised concerns that AT&T's control of its customer base would allow it to control the delivery of broadband content, to establish proprietary management and software protocols, and to negotiate exclusive arrangements with leading software and content providers.[7] It was in part to preclude these very possibilities that the Commission placed conditions on its approval of the AT&T/MediaOne merger.[8]

The impact of entry-deterring strategies is receiving increased attention in the economics literature and from antitrust authorities.[9] The Microsoft case focused on competitive problems arising from market power in complementary markets. The Department of Justice alleged that Microsoft attempted to tie applications software to its operating system software in order to protect its long-term market power in the operating system market. Public policy concerns with tying or vertical integration or foreclosure strategies appear to be particularly acute when it comes to information industries, in large part due to network externalities.[10] This should translate into a

[7] *Declaration of Daniel L. Rubinfeld and J. Gregory Sidak*, filed on behalf of GTE. CS Docket No. 99-241, August 23, 1999.

[8] *Applications for Consent to the Transfer of Control of Licenses and Section 214 Authorizations from MediaOne Group, Inc. to AT&T Corp.,* Memorandum Opinion & Order, CS Docket No. 99-251, 15 FCC Rcd 9816, 9864-9873, ¶¶110-125 (2000).

[9] Dennis W. Carlton and Michael Waldman, *The Strategic Use of Tying to Preserve and Create Market Power in Evolving Industries*, Working Paper #145, George J. Stigler Center for the Study of the Economy and the State, University of Chicago, July 1999

[10] Network externalities exist where the benefit of consuming a service is dependent on whether others consume the service as well. For example, an individual's willingness to use Microsoft Word is influenced by the popularity of Word with co-workers or professional colleagues.

greater willingness to impose requirements on the ILECs to offer unbundled elements and transport services, as a way of preventing competition problems in the future.

IV. Competitive providers of broadband services would be disadvantaged under the Commission's proposed rule change

Freeing the ILECs from the obligation to provide broadband DSL service on a wholesale basis will dramatically reduce the independent ISPs' ability to reach customers. As discussed above, the ILECs will have little incentive to reach agreements with non-affiliated ISPs, except at prices that are so high as to render it difficult at best and impossible at worst for the non-affiliated ISP to attract customers. Nor is it likely that there will be economic alternatives available to substitute for the ILECs' wholesale offerings. As a result, the ISPs will no longer be able to play a vital role as providers of applications based on the advanced technologies of the 21st century.

The experience in the cable industry is highly indicative of what is likely to happen if the Commission adopts its proposed rules. The cable industry has no general obligation to allow other ISPs to provide service over its network, and in fact, has essentially no wholesale arrangements with ISPs. The sole exceptions to this general statement are the arrangements reached as a result of the conditions that were placed on the AOL/Time Warner and AT&T/Comcast mergers. In those cases, the cable companies involved were required, as a condition of their merger approvals, to allow other ISPs access to their cable modem services. Even in these limited circumstances, however, there has been very little wholesale service of cable broadband service to unaffiliated ISPs. Absent a strong requirement to provide wholesale service, ILECs can be expected to behave in the same way the cable companies have.

It is also unlikely that unaffiliated ISPs would be able to build their own facilities to serve residential customers or rely on third parties to build these facilities. ISPs are not in the business of building local telecommunications networks, and thus will not necessarily have the expertise to build their own facilities to serve end users. Furthermore, any ISP alone will not have sufficient scale to justify building a network that is capable of serving all customers. It has also become

apparent that no CLEC can overcome the diseconomies of scale and build a ubiquitous local network to match the ILECs' networks.

The end result of this process will be that the ISPs will be unable to offer broadband services in large parts of the market.[11] And as customer demand for broadband-based information services increases and as the demand for narrowband-based services dries up, the ISPs will be foreclosed from any meaningful participation in the information services market. An industry that is now vibrant and highly competitive will be dominated in most markets by one or two firms (the ILEC and the cable company), which bundle broadband transmission together with service and content, and limit customers' ability to choose among different providers of information services.

V. Costs of Regulation

The ILECs argue that *Computer III* and other regulations should be eliminated because they raise their cost of doing business. They claim that this puts them at a competitive disadvantage relative to the cable companies, which are not subject to similar regulations. Whether the cable companies should also be subject to open access and unbundling requirements is a different issue, which will not be addressed here. Rather, I will take as a given the existing regulatory conditions and consider whether the social benefits of imposing regulations on the ILECs exceed the social costs.

[11] Even if the ISPs are able to obtain broadband transmission in some markets, they will be handicapped by the substantial cost disadvantage relative to the ILECs' and cable companies' ISP businesses. With fewer customers, an ISP will be less able to achieve economies of scale in the use of its local access points and other equipment, such as routers. An additional source of this cost disadvantage stems from the fact that the amount of advertising revenue that an ISP can collect is a function of the number of customers it has. With only a limited broadband offering or none at all, an unaffiliated ISP will have fewer customers, and thus will receive less advertising revenue.

In a recent *ex parte* filing in this docket, BellSouth attacked the *Computer Inquiry* rules on several fronts.[12] First, BellSouth quantified the "annual operating costs of complying with the rules in the provision of broadband Internet access" as amounting to approximately $45.28 per year per end user customer utilizing BellSouth's DSL network. Second, BellSouth estimated that the Universal Service contribution imposes an additional annual cost per customer of $36.00. They then point out that the sum of these two quantifiable cost disadvantages is $6.77 per customer per month. Third and finally, Bell South alleged that the regulatory regime imposes significant, but non-quantifiable, inefficiencies on the design of their broadband network. This analysis by BellSouth fails to address the essential issue of whether the benefits from greater competition in enhanced services markets will exceed the costs of regulation.

A. Even if accurate, BellSouth's claimed costs are not out of proportion to the benefits

BellSouth's filing features an estimated $45.28 per line per year due to infrastructure and operational inefficiencies. Since BellSouth provides no detailed support of this number it is impossible to critique this estimate with any specificity.[13] Nevertheless, even taken at face value, the estimated total costs, rather than the highlighted per line costs, are not very high when put in perspective. Bell South estimates that the total cost of these inefficiencies is $48.3 million per year. It then divides this estimate by its total number of DSL customers to yield the per line costs.

[12] BellSouth Corporation, Letter From L. Barbee Ponder IV, *Ex Parte* Presentation, WC Dockets Nos. 02-33, 98-10, 95-20; 01-337; CC Docket No. 02-52, July 10, 2003.

[13] It is worth noting, however, that $29.0 million of this is the cost of maintaining separate systems for regulated and non-regulated services for customer trouble handling, provisioning and installation, and ticketing and troubleshooting systems. BellSouth does not make clear in its filing why separate systems are necessary. In addition, BellSouth claims its must buy equipment specially made by its vendors to include the network and accounting demarcation points required under current regulations to allow competitors to use wholesale DSL service. BellSouth claims that this specially made equipment costs more because the only customers for it are the regulated ILECs, including itself and the BOCs. Even if the BOCs were the only customers for this "specially-made" DSL equipment, it seems likely that their purchases would be large enough to be the standard design, and that equipment without the demarcation points would be the "specially-made" and thus higher cost equipment.

But this misses the point that the economy-wide benefit from the regulations is not limited to the regulated firm. Indeed, the regulated firm might have a lower cost structure without regulation, allowing it reduce prices to its customers, but it is unlikely that the customers would receive those lower prices once the ILEC stopped providing access to their bottleneck network in response to the removal of regulation and drove the competitors out of business.

However, the beneficiaries of regulation are all present and future customers in the marketplace. This would include other carriers' DSL customers, the customers of other broadband services that ride the ILECs' network, as well as the cable companies' customers who will benefit from a more competitive market structure. Considering that the total residential broadband market is estimated to be about $29.5 billion dollars, nationwide,[14] $48.3 million per year is not a lot to pay for facilitating more vigorous competition in the marketplace. In fact, if we assume that all the ILECs will incur regulatory costs that are proportionate to BellSouth's, then these costs would still be less than one percent of total revenues in the market.

This is far below the benefits that society could obtain by bringing competition to the geographic and product markets where the ILECs are a monopoly, as well as to other markets where there are only two firms. BellSouth claims that the elimination of regulatory costs would lead to "lower prices for broadband services causing increased competitive pressure on all competing technologies and providers to do the same."[15] This ignores the obvious, which is that even where competition exists, it is very limited, and the so-called competitive pressure in duopoly markets will not create sufficient pressure to drive prices to cost.

In a different context, the Regional Bell Operating Companies (RBOCs) have recognized the potential harm to consumers from the pricing behavior of firms in a highly concentrated

[14] Jason Marcheck, "The High-Speed Data Outlook: Market Forecasts 2003-2007," August 2003.
[15] BellSouth, *Ex Parte* at 14.

market. In their 271 applications for authority to enter interLATA markets, the RBOCs alleged that three large carriers (AT&T, MCI, and Sprint) dominated the long distance market and that RBOC entry into this market could provide billions of dollars of benefits. For example, Bell Atlantic's economist in the New York 271 case estimated that by entering the long distance market, it would provide billions of dollars of benefits to consumers.[16] While the premise of non-competitive behavior in the long distance market was absurd, the logic that increasing competition can bring enormous consumer benefits is irrefutable, and especially relevant to the broadband markets at issue in this proceeding.

B. Universal Service Costs Are Irrelevant to this Case

In the most disingenuous of its claims, BellSouth complains that the imposition of a universal service fund contribution obligation on DSL, but not cable modem services, disadvantages DSL customers. This point is irrelevant to whether there are benefits to regulations requiring the ILECs to unbundled and offer network elements and broadband transport services under tariff. The only point of making this argument is to artificially inflate its estimate of the costs of regulation, and to shift the focus of this proceeding away from competition issues stemming from the ILECs' continued control over essential network elements and services. The burden of universal service contributions most certainly creates many distortions in the marketplace, but this problem should be confronted directly rather than by trying to offset one regulatory distortion with another. Two wrongs do not make a right.

It should nevertheless be noted that BellSouth's argument is actually harmful to its own case. If the market were as competitive as it claims, and only one of the firms in the market was

[16] *Application by Bell Atlantic New York for Authorization Under Section 271 of the Communications Act to Provide In-region, InterLATA Service in the State of New York,* Declaration of Paul MacAvoy, CC Docket No. 99-295 (1999).

subject to a very large government fee, we would expect to see that firm contracting its service rather than trying to compete with the unburdened competitors. This is clearly not the case, as BellSouth and the other RBOCs are aggressively trying to expand their DSL retail customer base. In fact, BellSouth itself announced a 53% year- over-year increase in DSL subscribers in its second quarter 2003 earnings report. If the universal service assessment on DSL but not cable modem service is as disadvantageous as BellSouth claims, then clearly marketplace pressures are not strong enough to drive higher cost firms out of business.

C. Allegations of Network Inefficiencies Are Unfounded

BellSouth's exposition of the network inefficiencies created by regulation is neither new nor useful to policymakers. The ILECs have been complaining about the network inefficiencies of competition policies, structural separation requirements, and unbundling requirements for decades. Moreover, BellSouth has exaggerated the nature of the network arrangements required under the *Computer III* rules, especially those related to protocol conversion.[17] In this filing, BellSouth also has continued the well-established practice of raising issues, but not trying to resolve them. They have made no attempt to estimate these costs, or more importantly to suggest alternative regulations that would still achieve the policy goal of allowing competition in the provision of advanced service, while improving the benefit-cost ratio. This "no never" approach to regulation makes sense only if the benefits can be ignored, or there is no way to implement regulations without imposing enormous costs on the industry. BellSouth has failed to prove that either of these conditions is true with respect to the rules governing access by ISPs to the monopoly broadband local facilities.

[17] Bell South claims that the *Computer II* rules force it to use inefficient methods of transporting data and impose unnecessary costs of performing protocol conversion in the optimal point in its network. The fallacy of this claim is

VI. Conclusion

"The lady doth protest too much, me thinks." [18]

Much of the cost of regulation of which the ILECs complain is not caused by the *Computer Inquiry* rules, but rather would be incurred by any ILEC seeking to offer wholesale broadband transport to unaffiliated ISPs. If the market for broadband transport were truly as competitive as the ILECs claim it to be, they would incur these costs willingly in order to increase sales and earn profits from wholesale services, rather than lose the business to their competitors. The ILECs' efforts to be freed of unbundling and open network requirements only makes sense because they are not constrained by competition in the transport market, and would benefit from foreclosing competition in downstream markets.

The ILECs' competitors in downstream markets are dependent upon the last-mile bottleneck facilities to provide telecommunications and information services. The *Computer Inquiry* rules, long standing common carrier regulations, and the requirements of the Telecommunications Act of 1996 have a vital purpose: to prevent the ILECs from leveraging their monopoly over last-mile facilities into downstream markets. These rules must be maintained and must apply to all bottleneck facilities – narrowband and broadband – to protect the competitive structure of downstream markets. These regulations impose costs, but they provide a far greater payoff, which cannot be ignored based on the false hope that the bottleneck has disappeared.

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discussed in a recent *ex parte* filing by AT&T. *See* Letter from David L. Lawson, Counsel for AT&T Corp., WC Docket Nos. 02-33, 98-10, 95-20, 01-337 (August 14, 2003).

[18] William Shakespeare, *Hamlet*, III, ii.